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In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. .....

WARREN TELEPHONE COMPANY,
Petitioner,

vs.

GUY T. HELVERING,
Commissioner of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

The petition of Warren Telephone Company respectfully shows to this Honorable Court:

A.

SUMMARY STATEMENT OF MATTER INVOLVED.

Petitioner did not distribute to its shareholders any part of its 1936 earnings, and in filing its income tax return for the year 1936 and in determining the surtax on undistributed profits imposed by Section 14* of the Revenue Act

---

* "Sec. 14. Surtax on Undistributed Profits.

(a) Definitions.—As used in this title—

(1) The term 'adjusted net income' means the net income minus the sum of—

(A) The normal tax imposed by section 13.
(B) * * *
(C) * * *
(D) * * *

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26(c), relating to contracts restricting dividends."

of 1936, petitioner, under the provisions of Section 26(c)(1) of the Revenue Act of 1936,* took credit in an amount equal to its adjusted net income upon the grounds that the provisions of its indenture and of its charter and stock certificates hereinafter referred to were express written contracts entered into prior to May 1, 1936, expressly dealing with and forbidding the distribution of any dividends for the year 1936.

Petitioner was incorporated under the General Corporation Laws of Ohio on April 13, 1926. (R. 32, 34.) On July 1, 1928, petitioner acquired all the assets of The Warren & Niles Telephone Company in exchange for all of the securities issued by petitioner, and on the same day commenced business. (R. 32.)

On September 24, 1928, petitioner executed and delivered an indenture dated as of May 1, 1928, securing an issue of first mortgage bonds in aggregate principal amount of $800,000. (R. 33, 36.) Article Eight, Sections 6, 9 and 14 of the indenture (R. 37) provided as follows:

"ARTICLE EIGHT.

Particular Covenants of the Company.

The Company hereby covenants and agrees:

* * * * *

Section 6. That it will not declare or pay any dividends on any of its capital stock at any time outstand-

---

* "Sec. 26. Credits of Corporations.

In case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(a) * * *

(b) * * *

(c) Contracts Restricting Payment of Dividends.—

(1) Prohibition of Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *"

ing except out of net earnings remaining after payment of all fixed charges, and after payment of all accrued installments of interest and sinking fund, if any, and maintenance fund in respect of bonds hereby secured and interest on all other funded and unfunded indebtedness and after proper observance of all the covenants hereof.

* * * * *

Section 9. That it will diligently preserve and maintain all the rights, privileges and franchises to it granted and upon it conferred, and will, * * *.

* * * * *

Section 14. That it will comply with the terms and conditions of any and all leases and contracts whether now existing or owned or hereafter entered into by it; that so long as any bonds are outstanding hereunder it will preserve its corporate organization and its right to transact business in every state in which it owns any property, and will do no act by which it might incur a forfeiture of its corporate existence or its right to so transact business, and that it will comply with all lawful statutes, acts and regulations affecting the Company or the mortgaged property.

* * * * *"

Section 2 of Article Ten of the indenture (R. 38) provided that if the Company defaulted in the due observance or performance of any covenant, condition or agreement of the indenture upon its part to be kept and performed and the same continued for a period of sixty days after written notice thereof from the trustee, then the trustee was authorized to and, upon the written request of the holders of one-fourth of the bonds outstanding, was compelled by written notice to the Company to declare the principal of all bonds secured and then outstanding to be due and payable immediately, and upon such declaration the same became immediately due and payable, giving to the trustee the right to enter and take possession of the mortgaged property, to institute foreclosure proceedings, appoint a receiver, etc. (R. 38, 39.)

Throughout the whole of the year 1936 petitioner had outstanding $800,000 principal amount of first mortgage bonds, and in December, 1936, petitioner requested the consent of the trustee under the indenture to the payment of dividends upon petitioner's preferred shares, to which the trustee replied:

> "Replying to wire, we cannot consent to payment dividends on your preferred stock because of deficit in your surplus account shown by audit report December 31, 1935, which deficit not removed by your estimated earnings this year. Stop. Payment of dividends would constitute violation covenant your trust indenture dated May 1, 1928, Section 6, Article 8." (R. 21, 22.)

Petitioner's articles of incorporation authorized the issuance of 5,000 $100 par preferred shares and 5,000 $100 par common shares, of which, on July 1, 1928, petitioner issued 2,450 preferred and 1,250 common shares, all of which were issued and outstanding throughout the years from July 1, 1928, to and including December 31, 1936. (R. 44.) Petitioner's articles of incorporation (R. 35, 36) and its stock certificates, both preferred and common (R. 44, 49), contained the following express provisions relating to the payment of dividends:

> "1. The holders of preferred stock shall be entitled to receive from and after the issuance thereof when and as declared by the Board of Directors from the surplus or net profits of this corporation, yearly dividends at the rate of 7% per annum and no more, payable quarterly on the first days of January, April, July and October in each year. The dividends on the preferred stock from and after its issuance, shall be cumulative and shall be payable before any dividend on the common stock shall be paid or set apart; so that if in any year dividends amounting to 7% shall not have been paid thereon the deficiency shall be paid or set apart before any dividends shall be paid or set apart for the common stock; the cumulations of dividends upon the preferred stock shall not bear interest.

"2. Subject to the foregoing provisions and not otherwise, such dividends as may be determined by the Board of Directors may be declared and paid on the common stock from time to time out of the remaining surplus or net profits of the company."

At the end of the year 1935 petitioner had a deficit in surplus account of $47,131.49. (R. 33.) Petitioner's taxable net income for the year ended December 31, 1936, is admittedly $29,028.97 (R. 16), an amount insufficient to make up the deficit of $47,131.49 existing December 31, 1935.

The respondent disallowed the credit claimed (R. 7-12) and petitioner appealed to the Board of Tax Appeals. (R. 3.) The Board of Tax Appeals affirmed respondent's finding. (R. 54-59.) Petitioner then filed a petition for review with the United States Circuit Court of Appeals for the Sixth Circuit (R. 74), which Court on June 2, 1942, affirmed the decision of the Board of Tax Appeals. (R. ....; 128 F. 2d 503) and on August 28, 1942, denied petitioner's application for rehearing. (R. ...)

B.

STATEMENT AS TO JURISDICTION.

1. Section 350 of Title 28, U. S. C., provides:

"No right of error, appeal, or writ of certiorari intended to bring any judgment or decree before the Supreme Court for review shall be allowed or entertained unless application therefor be duly made within three months after the entry of such judgment or decree. * * *"

The judgment of the ~~Board of Tax~~ Court of Appeals was filed June 2, 1942. (R. 84.) On June 30, 1942 (R. 89.), petitioner filed an application for rehearing, which was denied August 28, 1942. (R. 95.)

2. Section 347 of Title 28, U. S. C., provides:

"(a) In any case, civil or criminal, in a Circuit Court of Appeals, * * * it shall be competent for the

Supreme Court of the United States, upon the petition of any party thereto, * * *, to require by certiorari, * * * that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted right of error or appeal."

C.

QUESTIONS PRESENTED.

The questions presented are whether petitioner in determining its undistributed profits subject to surtax under Section 14 of the Revenue Act of 1936 was entitled to a credit in amount equal to its adjusted net income for 1936, by reason of the provisions of Section 14(a)(1)(A) and (2) and Section 26(c)(1) of the Revenue Act of 1936, in view of the deficit in petitioner's surplus account at the end of 1935, not removed by 1936 earnings, and the express written provisions, expressly dealing with the payment of dividends, found in petitioner's contracts as follows:

1. Petitioner's indenture dated as of May 1, 1928, but actually executed September 24, 1928, Article 8, Sections 6, 9 and 14 of which are set forth, *supra*, pages 2 and 3. (R. 37.)

2. Petitioner's Certificate of Amendment to its articles of incorporation, dated July 25, 1927 (R. 36), filed in the office of the Secretary of State, State of Ohio, July 29, 1927 (R. 34), sub-paragraphs 1 and 2 of paragraph numbered 5 of which are set forth, *supra*, pages 4 and 5. (R. 35.)

3. Petitioner's stock certificates, dated July 1, 1928 (R. 44, 45), evidencing petitioner's contracts with its shareholders, both preferred and common, which provisions are set forth, *supra*, pages 4 and 5. (R. 44, 49.)

D.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

1. The decisions of the United States Circuit Court of Appeals and that of the Board of Tax Appeals are probably based upon an erroneous interpretation of and are probably in conflict with the rule of law announced by this Court in *Helvering v. Northwest Steel Rolling Mills, Inc.*, (1940) 311 U. S. 46, and *Crane-Johnson Company v. Helvering*, (1940) 311 U. S. 54.

2. The decision of the United States Circuit Court of Appeals is in direct conflict with the decision of the United States Circuit Court of Appeals for the Third Circuit in the case of *Lehigh Structural Steel Company v. Commissioner* (March 27, 1942), 127 F. 2d 67. The Commissioner of Internal Revenue, respondent herein, filed no petition for writ of certiorari for review of the decision of the Circuit Court of Appeals for the Third Circuit in the *Lehigh Structural Steel Company* case.

3. The precise questions herein involved have never been before this Court, and in view of the decision of this Court in *Helvering v. Northwest Steel Rolling Mills, Inc., supra*, it is submitted that the same are of such general importance that this Court should announce the rules of law properly applicable thereto.

WHEREFORE your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Sixth Circuit, commanding that Court to certify and send to this Court, for its review and determination on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket "No. 9,014, Warren Telephone Company, Appellant and Petitioner Below, v. Commissioner of Internal Revenue, Appellee and

Respondent Below," and that the judgment of the United States Circuit Court of Appeals may be reviewed by this Honorable Court, and your petitioner have such other and further relief in the premises as to this Honorable Court may seem meet and just; and your petitioner will ever pray.

WARREN TELEPHONE COMPANY,
By H. H. HOPPE,
Its Attorney.

HOPPE, LEA, DAY & FORD,
702 Second National Building,
Warren, Ohio,
Of Counsel.

In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. .....

WARREN TELEPHONE COMPANY,
Petitioner,

vs.

GUY T. HELVERING,
Commissioner of Internal Revenue,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the United States Circuit Court of Appeals is set forth in the record at page ...., and is reported in 128 F. 2d, 503.

The opinion of the Board of Tax Appeals is set forth in the record on page 54, and is reported in 43 B. T. A. 451.

II.

JURISDICTION.

The grounds on which the jurisdiction of this Court is invoked are:

1. The provisions of Sections 347 and 350 of Title 28, U. S. C., set forth in the petition *supra*, page 5.

2. The decision of the United States Circuit Court of Appeals is probably based upon an erroneous interpretation of and is probably in conflict with the rule of law announced by this Court in *Helvering v. Northwest Steel Rolling Mills, Inc.* (1940), 311 U. S. 46.

3. The decision of the United States Circuit Court of Appeals in this case is in direct conflict with the decision of the United States Circuit Court of Appeals for the Third Circuit in the case of *Lehigh Structural Steel Company v. Commissioner* (1942), 127 F. 2d 67.

4. The precise questions herein involved have never been before this Court and, in view of the decision of this Court in *Helvering v. Northwest Steel Rolling Mills, Inc., supra,* it is submitted that the same are of such general importance that this Court should announce the rules of law properly applicable thereto.

III.

STATEMENT OF THE CASE.

A full statement of the case has been made in the petition, page 1, *supra.*

IV.

ERRORS ASSIGNED.

It is respectfully submitted that the United States Circuit Court of Appeals erred in holding that petitioner, in determining its undistributed profits subject to surtax under Section 14 of the Revenue Act of 1936, was not entitled to a credit in amount equal to its adjusted net income for 1936 under the provisions of Section 14(a)(1)(A) and (2) and Section 26(c)(1) of the Revenue Act of 1936, in view of the deficit in petitioner's surplus account at the end of 1935, not removed by 1936 earnings, and the express written provisions, expressly dealing with the payment of dividends, found in petitioner's contracts as follows:

1. Petitioner's indenture dated as of May 1, 1928, but actually executed September 24, 1928, Article 8, Sections 6, 9 and 14 of which are set forth in the petition, *supra,* pages 2 and 3, and in the record page 37.

2. Petitioner's Certificate of Amendment to its articles of incorporation dated July 25, 1927 (R. 36), filed in the

office of the Secretary of State, State of Ohio, July 29, 1927 (R. 34), subparagraphs 1 and 2 of paragraph numbered 5 of which are set forth in the petition, *supra*, pages 4 and 5, and in the record page 35.

3. Petitioner's stock certificates, dated July 1, 1928, evidencing petitioner's contracts with its shareholders, both preferred and common, which provisions are set forth in the petition, *supra*, pages 4 and 5, and in the record pages 44, 48 and 49.

V.

SUMMARY OF ARGUMENT.

Petitioner's 1936 income subject to tax was admittedly $29,029.97, the normal tax on which was $3,413.77 (R. 16.) Petitioner's "adjusted net income" under Section 14(a)(1)(A) of the Revenue Act of 1936 was therefore $25,616.20. As petitioner had an admitted deficit in capital account as of December 31, 1935, in the amount of $47,131.49 (R. 33), obviously not removed by 1936 earnings of $25,616.20, after normal tax, petitioner, in determining its surtax on undistributed profits imposed by Section 14, was, under the provisions of Section 14(a)(2) and Section 26(c)(1) of the Revenue Act of 1936, entitled to credit in the amount of its adjusted net income because:

1. It had a contract with its bondholders executed September 24, 1928 (R. 40), Section 6, Article 8 of which (R. 37) expressly provided that petitioner would not declare or pay any dividends on any of its capital stock at any time outstanding except out of net earnings.

2. It had a contract evidenced by its Certificate of Amendment to its articles of incorporation, executed by its President and Secretary on July 25, 1927 (R. 36), filed in the office of the Secretary of State of the State of Ohio July 29, 1927 (R. 34), in which it agreed that the holders of its preferred and common shares were to be entitled to receive dividends from its surplus or net profits, and not otherwise. (R. 35, 36.)

3. It had contracts with the holders of 2,450 of its authorized and outstanding $100 par 7% cumulative preferred shares and 1,250 of its authorized and outstanding $100 par common shares, all of which were issued and outstanding throughout the years from July 1, 1928, to and including December 31, 1936 (R. 44), evidenced by stock certificates (R. 47, 49, 51), which expressly provided that the holders thereof were entitled to receive dividends from its surplus or net profits, and not otherwise. (R. 49.)

VI.

ARGUMENT.

The record in the case of *Helvering v. Northwest Steel Rolling Mills, Inc., supra,* discloses that credit was there claimed under Section 26(c) because (1) of an *oral* agreement with a bank that all surplus money over and above that needed for current operating expenses would be applied by the company on its indebtedness to the bank (see Record in that case, pp. 46 and 47), and (2) because the company had a deficit in capital account and could not therefore declare any dividends under the laws of the State of Washington, the state of its incorporation, which laws were a part of its Articles of Incorporation or charter contract as shown by Article II, paragraph Nineteenth thereof, which provided that the company was formed

> "to exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington, and to do and perform all things necessary, proper or convenient for the carrying out of the objects and purposes herein specified."

From Footnote 17 (311 U. S. 52) it is apparent that the claim was likewise made that the laws of the State of Washington were by implication a part of the company's contracts with its shareholders as evidenced by its stock certificates, but the record fails to disclose just what contract the Northwest Steel Rolling Mills, Inc. had with its

shareholders for no stock certificate was there offered in evidence. This Court, in interpreting the provisions of Section 26(c)(1), said (311 U. S. 49):

> "The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered. True, obligations not set out at length in a written contract may be incorporated by specific reference, or even by implication. But Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. It did this by adding a precautionary clause that the granted credit can only result from a provision which 'expressly deals with the payment of dividends.' "

Was an "explicit understanding reached, reduced to writing, signed and delivered" in the case at bar, and is the "exempted prohibition against dividend payments expressly written in the executed contract"? We respectfully submit that it was on three different occasions.

First—In petitioner's indenture or deed of trust (R. 36), dated as of May 1, 1928, but actually executed and delivered on September 24, 1928, by petitioner's vice president and secretary, and under petitioner's seal (R. 40), under which $800,000 in principal amount of bonds were sold and delivered and which in Article Eight, Section 6, expressly provides (R. 37):

> "The Company hereby covenants and agrees:
>
> "Section 6. That it will not declare or pay any dividends on any of its capital stock at any time outstanding except out of net earnings remaining after payment of all fixed charges, and after payment of all accrued installments of interest and sinking fund, if any, and maintenance fund in respect of bonds hereby secured and interest on all other funded and unfunded indebtedness and after proper observance of all the covenants hereof."

Second—In petitioner's amended articles of incorporation (R. 34), executed by its President and Secretary and under its corporate seal (R. 36), dated July 25, 1927, filed in the office of the Secretary of State of the State of Ohio on July 29, 1927, which expressly limits the payment of dividends "from the surplus or net profits of this corporation."

Third—In petitioner's contracts with its shareholders evidenced by its stock certificates dated July 1, 1928, executed by its President and Secretary and under its corporate seal (R. 47-53), and delivered to its shareholders in July of 1928 (R. 44), which expressly limit the payment of dividends "from the surplus or net profits of this corporation."

We respectfully submit that a more literal compliance with this Court's construction and interpretation of Section 26(c)(1) of the Revenue Act of 1936 could scarcely be found.

1. The Provisions of Petitioner's Indenture.

The Circuit Court in its opinion stated that the provisions of petitioner's indenture were undoubtedly contractual obligations within the meaning of Section 26(c)(1), but stated that it was "not persuaded" that these provisions prohibited the payment of dividends in the situation in which petitioner found itself upon the termination of the tax year. This "lack of persuasion," we respectfully submit, is due to the fact that the Circuit Court confuses the words "net earnings"* with "net income subject to tax" under the Revenue Act of 1936. Thus the Circuit Court says:

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* The Circuit Court used the words "surplus or net profits" in speaking of the provisions of the indenture, instead of "net earnings" as found in the indenture. The words "surplus or net profits" are found in petitioner's charter and stock certificates. We submit they mean one and the same thing.

> "That there were such 'net profits' is proved, if not, indeed, conceded."

The only proof of "net profits" and the only "net profits" conceded were petitioner's net income for the year subject to tax, and certainly the fact that petitioner had net income for the year 1936 subject to tax under the Revenue Act of 1936 is certainly no evidence, proof or concession that petitioner had any "net earnings" within the meaning of those words as found in Section 6, Article 8 of petitioner's indenture. When we speak of "net income" or "net profits" subject to income tax, we obviously mean "net income" or "net profits" for one year, fiscal or calendar, for the reason that income taxes are imposed upon the net profits or the income for a year. However, the words "net earnings" as used in the indenture, without reference to any specific time, such as "net earnings for a year" or "net earnings for a month," can mean only the accumulated net earnings. As was said by the court in *Lich v. United States Rubber Company* (1931), 39 F. Supp. 675:

> "Where the capital is impaired, annual net earnings, if sufficient to offset the impairment, do not constitute the net profits. * * * The term 'net profits' is not synonymous with the term 'annual net earnings.' Annual net earnings may be productive of net profits, or, as in the instant case, reductive of the deficit."

Thus, contrary to the conclusion of the Circuit Court, we respectfully submit there was an express obligation undertaken by petitioner to refrain from declaring and paying dividends until such time as its capital deficit has been restored and a surplus accumulated. This most certainly was the position of the trustee under the indenture, which withheld its consent to the payment of any dividends

> "because of deficit in your surplus account shown by audit report December 31, 1935, which deficit not removed by your estimated earnings this year. Stop.

Payment of dividends would constitute violation covenant your trust indenture dated May 1, 1928, Section 6, Article 8." (R. 22.)

The position of the Circuit Court is that this assertion

> "by the trustees that they would treat the payment of dividends by the taxpayer as a breach of the provisions of the trust, is, of course, not conclusive of the taxpayer's obligation under the instrument, and in any event cannot bind the Government."

In this connection, however, it must be borne in mind that petitioner requested permission of the trustee only because of the letter which the respondent in his official position wrote to Messrs. Wideman & Madden of Toledo, Ohio, on December 23, 1936 (37-3-C. C. H. Par. 6025), in which respondent, under somewhat similar circumstances, stated that a provision of a mortgage held by the Federal Reserve Bank, prohibiting the payment of dividends so long as the mortgagor was indebted to the Federal Reserve Bank, would not in and of itself prevent the assessment of a surtax on undistributed earnings unless the mortgagor, upon request for permission to pay a dividend, was refused the right so to do.

Petitioner respectfully submits that the words "net earnings," as found in Section 6 of Article 8 of its indenture, can logically have but one meaning and that is the accumulated position of the company. The fact that the indenture provided that no dividends were to be paid except out of

> "net earnings remaining after payment of all fixed charges, and after payment of all accrued installments of interest and sinking fund, if any, and maintenance fund in respect of the bonds hereby secured, and interest on all other funded and unfunded indebtedness * * *."

which charges are annual in character, does not lead to the conclusion that what the parties referred to in the use of

the words "net earnings" was "net earnings for the year." The charges referred to, to-wit, payment of all fixed charges, payment of all accrued installments of interest and sinking fund, if any, and maintenance fund in respect to the bonds thereby secured, and interest on all other funded and unfunded indebtedness, were payable in all events, whether or not petitioner had any earnings for the year in which they fell due. And when we bear in mind the fact that the indenture in question was a first mortgage on all of petitioner's fixed assets, given as security for the payment of $800,000 of bonds, we can come to but one conclusion, and that is that by using the words "net earnings" the parties desired to protect the capital position of the company and to protect the interests of the bondholders by assuring them that the capital invested would not be dissipated by dividends but would remain in the company for the purpose of assuring operations with which to earn money and pay off the bonds. Thus it is obvious that the words "net earnings" were used to mean the "accumulated position of the company."

2 and 3. The Provisions of Petitioner's Charter and Stock Certificates.

Prior to the decision by this Court in *Helvering v. Northwest Steel Rolling Mills, Inc.*, respondent and the Board of Tax Appeals had both ruled that stock certificates were written contracts within the meaning of Section 26(c)(1).* The Solicitor General of the United States, in his brief on behalf of the Commissioner of Internal Revenue in the case of *Crane-Johnson Company v. Helvering, Commissioner of Internal Revenue,* 311 U. S. 54, which

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* I. T. 3139, 1937-2 C. B. 111; I. T. 3152, 1938-1 C. B. 155; *Airtherm Manufacturing Company v. Commissioner,* 43 B. T. A. 736; *Holden and Reaume, Inc. v. Commissioner,* Docket No. 100875, C. C. H., B. T. A. Decisions, No. 11695-F; P. H.-Memo. Dec. Par. 41139.

was a case exactly like that of *Helvering v. Northwest Steel Rolling Mills, Inc.*, said on pages 7 and 8:

> "Petitioner's alternative argument, not raised before the Board or properly presented to the court below, that its stock certificates were written contracts executed by it and that the North Dakota statute was a part of such contracts, is untenable. *Although stock certificates containing express restrictions against dividend payments would come under Section 26(c)(1),* a state law restricting dividend payments, which is at best an implied provision of the stock certificates, does not satisfy the requirements of the section." (Emphasis ours.)

Then came the decision of this Court in the *Northwest Steel Rolling Mills* case, which the Board of Tax Appeals interpreted as a ruling to the effect that Congress, in enacting Section 26(c)(1), meant to limit the contracts therein referred to, to "routine contracts dealing with ordinary debts."* Whereupon respondent revoked his prior rulings and in line with the decisions of the Board of Tax Appeals ruled that contracts within the meaning of Section 26(c)(1) were limited to routine contracts dealing with ordinary debts.**

This unreasonable interpretation is based upon the following language of this Court in the *Northwest Steel Rolling Mills* case (311 U. S. 49, 50):

> "First. It is material that we are dealing here with a generally imposed surtax upon the undistributed net income of corporations, and that respondent's claim is for a credit in the nature of a specially permitted deduction. It has been said many times that provisions granting special tax exemptions are to be strictly construed.

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* *Lehigh Structural Steel Company v. Commissioner*, 44 B. T. A. 422, 424; *Bishop & Babcock Mfg. Co. v. Commissioner*, 45 B. T. A. No. 123, page 4.

** I. T. 3525, 1941-52-I. R. B. p. 9.

"Measured by this sound standard it is probably not necessary to go beyond the plain words of section 26(c)(1) in search of the legislative meaning. Certainly, at first blush, few would suppose that when Congress granted a special exemption to corporations whose dividend payments were prohibited by executed written contracts, it thereby intended to grant an exemption to corporations whose dividend payments were prohibited by state law. The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered. True, obligations not set out at length in a written contract may be incorporated by specific reference, or even by implication. But Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. It did this by adding a precautionary clause that the granted credit can only result from a provision which 'expressly deals with the payment of dividends.'

"That the language used in section 26(c)(1) does not authorize a credit for statutorily prohibited dividends is further supported by a consideration of section 26(c)(2). By this section, a credit is allowed to corporations contractually obligated to set earnings aside for the payment of debts. That this section referred to routine contracts dealing with ordinary debts and not to statutory obligations is obvious—yet the words used to indicate that the section had reference only to a 'written contract executed by the corporation' are identical with those used in section 26(c)(1). There is no reason to believe that Congress intended that a broader meaning be attached to these words as used in section 26(c)(1) than attached to them under the necessary limitations of 26(c)(2)."

In other words, this Court very plainly said that the words "written contract executed by the corporation," found in both Sections 26(c)(1) and (2), meant the same thing and that statutory prohibitions were no more included within the meaning of the words "written con-

tract" found in Section 26(c)(1) than statutory obligations were within the meaning of the words "written contract" found in Section 26(c)(2).

The United States Circuit Court of Appeals for the Third Circuit, in the case of *Lehigh Structural Steel Company v. Commissioner,* (1942) 127 F. 2d 67, had no difficulty in interpreting the above quoted language of this Court. The amended certificate of incorporation of the Lehigh Structural Steel Company and its stock certificates contained a provision requiring a given amount of its net profits to be set aside in a sinking fund for the redemption in each year of a certain part of its outstanding preferred shares. The court held that these stock certificates were written contracts within the meaning of Section 26(c)(1) of the Revenue Act of 1936 and refused to limit the words "written contract" as found in Section 26(c)(1) to "routine contracts dealing with ordinary debts." In so doing the court said (127 F. 2d 67, 68):

> "The decision in the *Northwest Steel Rolling Mills* case was that a corporation which is prohibited by state law from paying dividends is not entitled to the credit allowed by Section 26(c)(1). The court reached this decision by examining the language used in the section and by the legislative history of its adoption. It concluded that the language used in Section 26(c)(1) does not apply to prohibition of dividend payments by state law since the state law is not a contract. This conclusion was also supported by the legislative history of the act which shows conclusively that Congress did not intend to give corporations with a capital deficit relief from the surtax on undistributed profits. The court concluded also that the language used in Section 26(c)(1) does not apply to the prohibition of dividend payments by state law incorporated in the corporate charter by implication since the prohibition is not expressly written in the charter. In answer to the contention that the charter was a written contract the court stated that although the charter is a contract

insofar as it grants rights, properties, privileges and franchises, the provision which requires the corporation to conform to state law is not contractual. Essentially what prohibited the payment of dividends was not the charter but the state law. In answer to the contention that the certificate of stock represented the contract the court stated that what it had said as to the charter applied to the certificate of stock. This method of disposing of the argument based upon the certificate of stock was most logical, since the certificate of stock, just as the charter, was silent as to the restraint upon the payment of dividends and could be said to contain a prohibition only if the state law were read into it. We find nothing in the opinion to warrant the argument that neither a charter nor a certificate of stock can ever be the kind of 'written contract' which is meant by Section 26(c)(1)."

Respondent did not petition for a writ of certiorari to review this decision of the Third Circuit Court of Appeals. The decision was wholly in accord with the position of his counsel in the *Crane-Johnson* case, where the Solicitor General in his brief (pp. 20, 21) before this Court argued:

"And the conclusion thus reached is supported by consideration of the provisions of Section 26(c)(2) which are *in pari* materia with those of Section 26(c)(1). Section 26(c)(2) provides for a credit equal to such of the earnings of the taxable year as are required 'by a provision of a written contract executed by the corporation prior to May 1, 1936,' to be paid in discharge of a debt or to be irrevocably set aside for the discharge of a debt. Since, so far as we have been able to ascertain, no state imposes as a requirement of law that corporate debts shall be discharged out of earnings, the words 'a provision of a written contract executed by the corporation,' as used in Section 26(c)(2), must obviously refer only to voluntary corporate undertakings. The same words, as used in the cognate provisions of Section 26(c)(1), should, of course, be similarly construed in the absence of any compelling reasons to the contrary."

The court below, however, and with reference to petitioner's charter and stock certificates, said (R. ....., 128 F. 2d 503, at 505 and 506):

> "The court, in the *Northwest Steel Rolling Mills* case (311 U. S. 46, 61 S. Ct. 112, 85 L. Ed. 29), after pointing out that the credit permitted under § 26(c)(1) is a special tax exemption to be strictly construed, reasoned that by the section 'a credit is allowed to corporations contractually obligated to set earnings aside for the payment of debts,' and that the section refers to 'routine contracts dealing with ordinary debts and not to statutory obligations.' We may therefore conclude, without discussion, that the provisions in the taxpayer's charter do not constitute a written contract signed and executed by the corporation, which, under the statute as interpreted, must exist to make available to the taxpayer the exemption permitted by § 26(c)(1).
>
> * * * * *
>
> The commitments contained in the stock certificates are but references to and repetitions of the charter provisions, and stand on no higher ground. Moreover, they are not contracts entered into by the corporation with creditors and are but internal agreements within the framework of corporate organization, and impose no external prohibition upon the corporation in respect to dividends.
>
> "This view is not in accord with that of the Third Circuit Court of Appeals in *Lehigh Structural Steel Co. v. Commissioner*, 3 Cir., 127 F. 2d 67, decided March 27, 1942. The court there reasoned that while it was logical to exclude from within the connotation of contract as the term is used in § 26(c)(1), a charter or stock certificate which contains no restraint upon the payment of dividends and may be so interpreted only by reading into it state law, it does not follow that a charter or certificate which expressly restrains payment of dividends may not be a written contract within the meaning of the section. In our view, the rationale of the *Northwest Steel Rolling Mills* case is broader than that. The *Lehigh* case overlooks the interpretation that the section refers 'to routine contracts deal-

ing with ordinary debts.' Having in mind its legislative history and the apparent purpose of the Congress to exempt corporations from the imposition of the tax upon deferred dividends only when the corporation has put it beyond its power to declare them by prior contract obligation to creditors (not stockholders), we hold the present issue to be controlled by the *Northwest Steel Rolling Mills* case."

Petitioner respectfully submits that the decision of the court below is clearly erroneous. There is nothing in Section 26(c)(1) nor in the language of this Court in the *Northwest Steel Rolling Mills* case which requires the written contract prohibiting the payment of dividends to be with any particular person or class of persons.

No question was raised below but what petitioner's charter and stock certificates are contracts. If there were any question in that regard it would be determined by the law of Ohio. *Blair v. Commissioner of Internal Revenue,* 300 U. S. 5; *Dayton & Michigan Railway Co. v. Commissioner of Internal Revenue,* 112 F. 2d 627. The Supreme Court of Ohio has definitely held stock certificates issued by Ohio corporations to be contracts between the corporation and the holders of such certificates. *Geiger v. Seeding Machine Co.,* 124 O. S. 222; *Johnson v. Lamprecht,* 133 O. S. 567; *Wildermuth v. Coal & Dock Co.,* 138 O. S. 1. Nor can there be any question but what the provisions of petitioner's charter and stock certificates prohibit the payment of dividends from any source other than its surplus or net profits. Respondent argued below that the provision of petitioner's charter and stock certificates, to-wit, that

"the holders of preferred stock shall be entitled to receive * * * from the surplus or net profits of this corporation, yearly dividends at the rate of 7% per annum and no more. * * *"

and that

"Subject to the foregoing provisions and not otherwise * * * dividends * * * may be declared and paid

> on the common stock from time to time out of the remaining surplus or net profits of the Company."

serves only to "establish" the right of shareholders to dividends and does not "circumscribe" it or limit their dividend rights.

Petitioner respectfully submits that this claimed interpretation by the respondent, not passed on by the court below, is as unreasonable as respondent's interpretation of the language of this Court in the *Northwest Steel Rolling Mills* case and his contention in connection therewith, to-wit, that written contracts under Section 26(c)(1) of the Revenue Act of 1936 are limited to contracts with creditors. Respondent cited no authorities below in support of his position. On the contrary there are cases expressly holding that where the stock certificates provide that dividends shall be paid out of a certain fund such provisions both "establish" and "circumscribe" the fund out of which dividends can be paid. *Gallagher v. New York Dock Company,* 19 N. Y. S. 2d 789, affirmed 32 N. Y. S. 2d 348; *Murphy v. Richardson Dry Goods Company,* 326 Mo. 1. See also *Hatch v. Neward Telephone Company,* 34 O. A. 361; *Will v. United Lanke Plantation Company* (1912), 2 Ch. 571; *Stone v. Envelope Company,* 119 Me. 394. Certainly when the provisions of the charter and stock certificates are that the preferred shareholders shall be entitled to dividends

> "from the surplus or net profits * * * at the rate of 7% per annum and *no more.*"

and this is immediately followed by the wording that

> "subject to the foregoing provisions *and not otherwise* such dividends * * * may be declared and paid on the common stock from time to time out of the *remaining* surplus or net profits of the Company."

there can be no question but what the right of both preferred and common shareholders to dividends was estab-

lished and limited to the surplus or net profits of the company.

Petitioner respectfully submits that this its petition for writ of certiorari should be granted and that the judgments of the United States Circuit Court of Appeals for the Sixth Circuit and of the Board of Tax Appeals below should be reversed.

Respectfully submitted,

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Counsel for Warren Telephone Company.

HOPPE, LEA, DAY & FORD,

Of Counsel.

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 550

WARREN TELEPHONE COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE PRESIDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 54–59) is reported at 43 B. T. A. 451. The opinion of the Circuit Court of Appeals (R. 84–88) is reported at 128 F. (2d) 503.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 2, 1942 (R. 84), and its order denying the petitioner's petition for rehearing (R. 89–94) was entered on August 28, 1942 (R. 95). The petition for a writ of certiorari was

filed on November 27, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

Whether the petitioner, in computing its undistributed net income for purposes of the surtax on its undistributed profits imposed by Section 14 of the Revenue Act of 1936, is entitled to a credit under Section 26 (c) (1) on the ground that its bond indenture and its amended articles of incorporation as reproduced on its stock certificates, constitute written contracts executed by the corporation expressly dealing with and prohibiting the payment of dividends during the taxable year 1936.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 1a–17.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 54–59), and supplemented by excerpts from the exhibits, may be summarized as follows:

Taxpayer is a corporation organized in 1926 in the State of Ohio, and engaged in the business of supplying telephone service in Trumbull County, Ohio. It is a public utility subject to the jurisdiction of the Public Utilities Commission of Ohio. On July 1, 1928, taxpayer acquired all of the assets of the Warren and Niles Tele-

phone Company in exchange for all of taxpayer's securities; taxpayer then began doing business (R. 54–55).

From 1928 to and including December 31, 1936, taxpayer had issued and outstanding 2,450 of its authorized $100 par seven percent cumulative preferred shares and 1,250 of its authorized $100 par common shares (R. 44). In December of 1936 all the preferred stock was owned by a single shareholder (R. 57). In respect of the preferred and common stock, the certificate of amendment to the articles of incorporation provided as follows (R. 35, 36):

> 1. The holders of preferred stock shall be entitled to receive from and after the issuance thereof when and as declared by the Board of Directors from the surplus or net profits of this corporation, yearly dividends * * *.
>
> 2. Subject to the foregoing provisions and not otherwise, such dividends as may be determined by the Board of Directors may be declared and paid on the common stock from time to time out of the remaining surplus or net profits of the company. * * *

The same provisions are reproduced on the back of the stock certificates (R. 49).

On September 24, 1928, taxpayer executed and delivered to the Continental National Bank & Trust Co. of Chicago, as trustee, and William P.

Kopf, as co-trustee, an indenture dated as of May 1, 1928, securing an issue of first mortgage six percent gold bonds, Series A, in the aggregate principal amount of $800,000 (R. 55). The indenture, in pertinent part, provided (R. 55–56):

> SECTION 6. That it will not declare or pay any dividends on any of its capital stock at any time outstanding except out of net earnings remaining after payment of all fixed charges, and after payment of all accrued installments of interest and sinking fund, if any, and maintenance fund in respect of bonds hereby secured and interest on all other funded and unfunded indebtedness and after proper observance of all the covenants hereof.
>
> * * * * *
>
> SECTION 9. That it will diligently preserve and maintain all the rights, privileges and franchises to it granted and upon it conferred * * *.
>
> * * * * *
>
> SECTION 14. * * * that so long as any bonds are outstanding hereunder it will preserve its corporate organization and its right to transact business in every state in which it owns any property, and will do no act by which it might incur a forfeiture of its corporate existence or its right to so transact business, and that it will comply with all lawful statutes, acts and regulations affecting the Company or the mortgage property.

By the terms of the indenture taxpayer was not required to set up a sinking fund, nor did it do so. The only provision contained in the indenture in this respect was that the bond interest be on deposit by a certain date. In the taxable year in question (1936) taxpayer had met all its obligations to the bondholders with respect to payment of interest and other charges, having paid the interest on May 1 and November 1, 1936. Pursuant to a resolution of its board of directors of December 29, 1936, taxpayer made application to the trustee under the bond indenture for permission to pay a cash dividend in the amount of its estimated net profit for 1936 upon its preferred stock so that the preferred stockholders might receive it by December 31, 1936 (R. 57). The trustee denied permission, stating in its telegraphed reply that it could not consent (R. 57)—

> * * * because of deficit in your surplus account shown by audit report December 31, 1935, which deficit not removed by your estimated earnings this year stop payment of dividends would constitute violation covenant under trust indenture dated May 1, 1928, Section 6, Article 8.

Taxpayer's statement of operations showed net income, dividends paid and surplus from 1928 through December 31, 1936, as follows (R. 55):

	Net income	Preferred dividends	Surplus
July 1, 1928			None
Dec. 31, 1928	[1] $17,606.32	None	[2] $17,606.32
Year—1929	31,191.79	$25,725	[1] 12,139.53
1930	28,423.66	17,150	[2] 865.87
1931	[1] 21,037.94	17,150	[2] 39,053.81
1932	[1] 46,188.54	None	[2] 85,242.35
1933	546.28		
Adjustment for prior years	4,990.04	None	[2] 79,706.03
Year—1934	17,942.24	None	[2] 61,763.79
1935	14,632.30	None	[2] 47,131.49
1936	[2] 23,880.31	None	[2] 23,251.18

[1] Net loss.

[2] Deficit.

[3] It should be noted that the Commissioner's computation for entry of decision states the net income for surtax computation for the year 1936 to be $29,028.97 (R. 61), and that taxpayer filed its consent to the settlement on that basis (R. 73). See also footnote 1 in the findings of fact of the Board of Tax Appeals, at R. 55.

In its income tax return for 1936 taxpayer claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936, on the ground that dividends could not be paid without violating the provisions of the bond indenture (admittedly a written contract executed by the corporation prior to May 1, 1936). The Commissioner denied the credit, and found a deficiency in taxpayer's income tax accordingly (R. 10). Taxpayer filed a petition for redetermination with the Board of Tax Appeals (R. 3–12). After the promulgation of the Board's opinion on January 30, 1941 (R. 54), taxpayer filed a motion for rehearing and reconsideration, claiming further that the provisions of the amended articles, stock certificates, and order of the Public Utilities Commission constituted restrictions upon the payment of dividends under the provisions of Section 26 (c) (1)

(R. 63–73). The Board granted the taxpayer's motion to the extent of reopening the hearing for the purpose of receiving as part of the record a stipulation of facts (R. 44–45), but denied it in all other respects (R. 53). Judgment was entered in favor of the Commissioner (R. 74), from which the taxpayer appealed (R. 74–80); the court below affirmed (R. 84–88).

DISCUSSION

The petitioner seeks a credit with respect to its 1936 undistributed profits tax under Section 26 (c) (1) of the Revenue Act of 1936, which exempts undistributed profits which the corporation could not distribute as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends." Petitioner contends that there exist three such contracts which entitled it to the credit in question: (a) its bond indenture, (b) its charter, and (c) its stock certificates which contained in *ipsissimis verbis* the pertinent language of the charter.

(1) As to the bond indenture, both the Board and the court below correctly ruled that the 1936 earnings could have been distributed as dividends without violating the terms of the indenture. That interpretation of the indenture was correct, and neither raises a conflict nor presents any question calling for further review.

(2) As to the charter and stock certificates, the court below ruled that petitioner was not entitled to the credit because neither the charter nor the stock certificates were "contracts" within the meaning of Section 26 (c) (1). Relying upon the general theory of *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46, the court held that the word "contract" in Section 26 (c) (1) was intended to refer to ordinary contracts entered into by the corporation with creditors, and not to internal agreements within the corporate framework such as those involved in the charter and stock certificates here. In reaching that result the court differed with *Lehigh Structural Steel Co.* v. *Commissioner,* 127 F. (2d) 67 (C. C. A. 3d), which held that such agreements were "contracts" within the meaning of Section 26 (c) (1).

Although it would be appropriate for the Court to grant certiorari in view of the conflict, the result reached below is nevertheless clearly correct on other grounds not touching the question of the *Lehigh* case. For, even if the charter and stock certificates be regarded as "contracts," they could not prevent the distribution of petitioner's 1936 earnings to the holder of its preferred stock. The charter and certificates merely provided that the preferred stock was entitled to dividends "from the surplus or net profits" of the corporation. And although petitioner did not have a surplus in 1936, as a result of prior deficits, it

certainly had "net profits." Indeed, these identical net profits were subjected to normal tax for 1936.

Moreover, the foregoing provision in the charter and stock certificates contained no prohibition whatever. It provided simply that the preferred shareholder should be entitled to receive dividends from surplus or net profits; the corporation would not violate its terms even by paying the dividend directly out of capital. The provision was designed to *establish* the right of the preferred stockholder to dividends rather than to *circumscribe* it.

Accordingly, the result below is correct irrespective of the issue involved in the conflict with the *Lehigh* case. Furthermore, in view of the relief provisions (retroactive to 1936) with respect to deficit corporations in the Revenue Act of 1942 the question presented by the conflict may become moot in a number of the pending cases.[1] However, although the issue appears to be alive in some of the cases still pending, the Treasury cannot readily ascertain at this time how extensive

[1] Section 501 of the Revenue Act of 1942 (Public Law No. 753, 77th Cong., 2d Sess.), enacted October 21, 1942, amends the Revenue Act of 1936 and allows additional credits in the case of deficit corporations. We are informed that a tentative computation made upon the assumption that the petitioner herein is entitled to these additional benefits results in the elimination of the greater portion of the deficiency here involved. In the case of other taxpayers, the new provisions may entirely eliminate contested deficiencies.

its administrative problem may be in winding up cases still remaining under the 1936 Act which involve this issue; but to the extent that the conflict exists it impedes the orderly disposition of those remaining cases.

Respectfully submitted.

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DECEMBER 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

[Here follow graduated rates.]

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts restricting payment of dividends.*—

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of

the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Revenue Act of 1942, Public Law 753, 77th Congress, 2d Session:

SEC. 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX.

(a) *Amendments to the Revenue Act of 1936.*—

(1) Section 14 (a) (2) of the Revenue Act of 1936 (relating to definition of undistributed net income) is amended to read as follows:

"(2) The term 'undistributed net income' means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g)."

(2) Section 26 (c) of the Revenue Act of 1936 (relating to credits of corporations) is amended by amending the heading to read as follows: "(c) *Restrictions on payment of dividends.*—"; and by amending paragraph (3) to read as follows:

"(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

"(4) *Double credit not allowed.*—If more than one of the credits provided in the foregoing paragraphs (1), (2), and (3) apply, then the paragraph which allows the greatest credit shall be applied; and, if the

credit allowable under each paragraph is the same, only one of such paragraphs shall be applied."

(3) Section 26 of the Revenue Act of 1936 (relating to credits of corporations) is amended by adding at the end thereof the following new subsections:

"(f) *Deficit credit.*—The amount by which the adjusted net income exceeds the sum of (1) the earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, and (2) the earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year). For the purposes of this subsection, earnings and profits of the taxable year shall be computed without diminution by the amount of the tax imposed under section 14, 102, 103, or 351 for such taxable year; and earnings and profits accumulated after February 28, 1913, as of the beginning of the taxable year, shall be diminished on account of the tax under section 14, 102, 103, or 351 for any previous taxable year only by the amount of such tax as computed under the amendments made by section 501 of the Revenue Act of 1942.

* * * * *

(b) *Effective date of amendments.*—The amendments made by subsection (a) shall be effective as of the date of the enactment of the Revenue Act of 1936.

(c) *Overpayments.*—If the refund or credit of any overpayment for any taxable year, to the extent resulting from the application of this section, is prevented on the date of the enactment of this Act or within one year from such date, then, notwith-

standing any other provision of law or rule of law (other than this subsection and other than section 3761 of the Internal Revenue Code or section 3229 of the Revised Statutes, or such section as amended by section 815 of the Revenue Act of 1938, relating to compromises), such overpayment shall be refunded or credited in the same manner as in the case of an income tax erroneously collected under the Revenue Act of 1936, if claim therefor is filed within one year from the date of the enactment of this Act.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the

earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without

violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1942